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CLIENT UPDATE

ENHANCED PRUDENTIAL STANDARDS FOR FOREIGN BANKING ORGANIZATIONS – A GUIDE FOR EACH FBO TYPE

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Introduction

On Tuesday, February 18, 2014, the Federal Reserve Board (the "Federal Reserve") adopted a final rule (the "Final Rule") implementing the enhanced prudential standards of Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") for U.S. bank holding companies ("BHCs") and foreign banking organizations ("FBOs") with a U.S. banking presence.[1] The Final Rule implements two proposed rules (the "Proposed Rules") issued in December 2011 and 2012, which proposed enhanced prudential standards and early remediation requirements for U.S. BHCs, FBOs, and nonbank financial companies designated systemically important ("Nonbank SIFIs") by the Financial Stability Oversight Council (the "FSOC").[2]

The Final Rule adopts standards that increase in stringency with the overall size and U.S. presence of an FBO, based on four size

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1 Federal Reserve Board, *Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations* (Feb. 18, 2014), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140218a1.pdf. To be subject to the Final Rule, an FBO must have a U.S. banking presence (*i.e.*, a branch, agency, commercial lending company or insured depository institution in the United States). References to FBOs herein refer to such organizations.

2 Federal Reserve Board, *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*, 77 Fed. Reg. 594 (Jan. 5, 2012); *Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies*, 77 Fed. Reg. 76629 (Dec. 28, 2012).

categories, as described in more detail below. The largest FBOs are required to establish a U.S. intermediate holding company ("IHC") that is essentially regulated like a U.S. BHC. The Final Rule more closely aligns the treatment of domestic and foreign institutions than would have been the case under the Proposed Rules, by increasing the threshold for the required IHC from $10 billion to $50 billion in U.S. non-branch assets ($50 billion also is the asset threshold for the application of most enhanced prudential standards to U.S. BHCs).

The Federal Reserve refrained from finalizing two key aspects of the Proposed Rules: single-counterparty credit exposure limits ("SCCL") and an early remediation framework. The Federal Reserve said that it continues to develop the SCCL requirement, noting its participation in an effort of the Basel Committee on Banking Supervision to develop a large exposure regime for global banks (rumored to be scheduled for finalization in March), and that this effort, as well as a quantitative impact study and further review of comments on the Proposed Rules, will inform efforts to establish an SCCL in the United States. With respect to the early remediation framework, which is required by Section 166 of the Dodd-Frank Act, the Federal Reserve stated in the preamble to the Final Rule that it "continues to review" concerns raised by commenters, such as objections that the proposed framework was overly broad in scope and inappropriately limited the Federal Reserve's discretion to take appropriate remedial action. In addition, the Federal Reserve determined not to apply enhanced prudential standards to Nonbank SIFIs in the Final Rule, stating that it will continue to assess the business models, capital structures and risk profiles of Nonbank SIFIs and apply enhanced prudential standards to them at a later date by rule or by order, subject to a public comment process.

This Client Update describes the enhanced prudential requirements of the Final Rule applicable to the four categories of FBOs, including, for the largest FBOs with a large U.S. presence, requirements governing the establishment of an IHC. *More specifically, Section 1 of this update provides a summary of the scope and principal requirements of the Final Rule, and Sections 2-5 focus on the specific requirements for each of the four major types of FBOs categorized by the Final Rule*. Appendix A provides a timeline for compliance with the Final Rule. Appendix B provides an overview of the scope of the Final Rule and the increasing requirements based on asset size and the size and type of an FBO's U.S. presence.

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1. *Scope, Summary Requirements and Compliance Deadline*

1.1 Scope

The Final Rule applies to four categories of FBOs with a U.S. banking presence:

- FBOs with greater than $10 billion but less than $50 billion in global consolidated assets ("Small FBOs") (See Section 2 below).
- Publicly-traded FBOs with $10 billion or more but less than $50 billion in global consolidated assets ("Publicly-Traded Small FBOs") (See Section 3 below).
- FBOs with $50 billion or more in global consolidated assets but less than $50 billion in U.S. assets ("Large FBOs with a Limited U.S. Presence") (See Section 4 below).
- FBOs with $50 billion or more in global consolidated assets and $50 billion or more in U.S. assets ("Large FBOs with a Large U.S. Presence") (See Section 5 below).

Large FBOs with a Large U.S. Presence that have non-branch U.S. assets of $50 billion or more will be required to form and hold U.S. subsidiaries (including branch subsidiaries) in an IHC. The $50 billion non-branch U.S. assets threshold for the IHC requirement is an important change from the Proposed Rules, which would have required FBOs with $50 billion or more in total consolidated assets and $10 billion or more in non-branch U.S. assets to establish IHCs. The higher threshold responds to arguments by commenters that FBOs with less than $50 billion in non-branch U.S. assets do not threaten U.S. financial stability, and that a $50 billion threshold would be more consistent with the asset threshold for application of most enhanced prudential standards to U.S. BHCs.

1.2 Summary Requirements

- **Small FBOs** will be subject to home-country annual capital stress testing requirements.
- **Publicly-Traded Small FBOs** will be required to form a U.S. risk committee.
- **Large FBOs with a Limited U.S. Presence** will be subject to risk management, home-country annual stress testing requirements, home-country capital certification and reporting and liquidity requirements.
- **Large FBOs with a Large U.S. Presence** will be subject to more stringent risk management, stress test, capital and liquidity requirements; moreover, Large FBOs with a Large U.S. Presence that have U.S. non-branch assets of $50 billion or more will be required to hold almost all U.S. subsidiaries under (based on banking "control" concepts) an IHC that essentially will be regulated like a U.S. BHC, including being subject to BHC risk-based and leverage capital requirements (subject to certain

exceptions). A diagram of these categories of FBOs and the applicable requirements is included as Appendix B.

1.3 Compliance Deadline

Key compliance dates are set out below. A more detailed compliance timeline is included as Appendix A.

- **January 1, 2015**: Large FBOs with a Large U.S. Presence that are required to establish an IHC must submit to the Federal Reserve by January 1, 2015 an implementation plan for compliance with the Final Rule.
- **July 1, 2016**: Compliance with most provisions of the Final Rule is required as of July 1, 2016 for FBOs that meet the relevant asset thresholds as of June 30, 2015.
- **October 1, 2017**: For IHCs, stress test requirements are effective on October 1, 2017.
- **January 1, 2018**: For IHCs, leverage capital requirements are effective on January 1, 2018.

An FBO that becomes subject to the IHC requirement after June 30, 2015 must form its IHC two years after its U.S. non-branch assets exceed the $50 billion threshold.

2. *Small FBOs*

2.1 Stress Testing

Small FBOs must be subject to a consolidated capital stress testing regime by its home-country supervisor, which must include (i) an annual (x) supervisory capital stress test conducted by the home-country supervisor or (y) evaluation and review by the home-country supervisor of an internal capital adequacy stress test conducted by the FBO and (ii) requirements with respect to stress testing governance and controls. The FBO must meet minimum standards set by its home-country supervisor with respect to stress tests.

A Small FBO that does not meet the stress testing requirements will be subject to a 105 percent asset maintenance (*i.e.*, its assets must be 105 percent of its liabilities) requirement for its U.S. branches and agencies, and will be required either to conduct (1) an annual stress test of its U.S. subsidiaries and report the results of this test to the Federal Reserve, or (2) an enterprise-wide stress test that is approved by the Federal Reserve. The asset maintenance requirement cannot be satisfied by parent support.

3. *Publicly-Traded Small FBOs*

3.1 Risk Committee

Consistent with the Proposed Rules, the Final Rule requires a Publicly-Traded Small FBO to annually certify to the Federal Reserve that it maintains a risk committee responsible for oversight of the risk management policies of the FBO's combined U.S. operations. The risk committee must have at least one member with experience in identifying, assessing, and managing risk exposures of a large, complex (but not necessarily financial) firm. The U.S. risk committee can be maintained as a stand-alone committee of its global board of directors (or equivalent thereof) or as a part of the board's enterprise-wide risk committee.

4. *Large FBOs with a Limited U.S. Presence*

4.1 Capital Certification and Reporting

Large FBOs with a Limited U.S. Presence (*i.e.*, less than $50 billion) will be subject to regulatory capital certification and reporting requirements, which include a requirement to certify on a consolidated basis to the Federal Reserve on a quarterly basis that it meets home-country capital adequacy standards that are consistent with the Basel Capital Framework, including Basel III. An FBO that is not subject to a home-country capital framework consistent with Basel III must demonstrate to the satisfaction of the Federal Reserve that it would meet or exceed consolidated capital standards that are consistent with the Basel III framework. If a Large FBO with a Limited U.S. Presence cannot make this certification, the Federal Reserve may impose requirements, conditions or restrictions relating to the activities or business operations of the FBO's U.S. operations, including risk-based or leverage capital requirements.

In addition, Large FBOs with a Limited U.S. Presence will be required to report risk-based capital ratios, risk-weighted and total assets to the Federal Reserve on a quarterly basis. The Federal Reserve said it intends to propose separately amendments to Form FR Y-7Q to incorporate the items that will need to be reported.

4.2 Liquidity

Large FBOs with a Limited U.S. Presence must conduct and report to the Federal Reserve the results of internal liquidity stress tests for either their consolidated operations or their combined U.S. operations. The liquidity stress tests must incorporate 30-day, 90-day, and one-year time horizons, and must be conducted consistently with Basel principles for liquidity risk management.

Failure to do so would subject an FBO's U.S. branch and agency network to intragroup funding restrictions, *i.e.*, the net aggregate amount owed by an FBO's head office and its non-U.S. affiliates to the combined U.S. operations could not exceed 25% of the third-party liabilities of the FBO's combined U.S. operations on a daily basis.

4.3 Risk Committee

A Large FBO with a Limited U.S. Presence will be required to annually certify to the Federal Reserve that it maintains a risk committee responsible for oversight of the risk management policies of the FBO's combined U.S. operations. The risk committee must have at least one member with experience in identifying, assessing, and managing risk exposures of a large, complex (but not necessarily financial) firm.

The risk committee requirement can be maintained on a stand-alone basis or as a part of the enterprise-wide risk committee of the global board of directors (or equivalent thereof).

4.4 Stress Testing

A Large FBO with a Limited U.S. Presence must be subject to a consolidated capital stress testing regime in its home country, which must include (i) an annual (x) supervisory capital stress test conducted by the home-country supervisor or (y) evaluation and review by the home-country supervisor of an internal capital adequacy stress test conducted by the FBO and (ii) requirements for governance and controls of stress testing. The FBO must meet minimum standards set by its home-country supervisor with respect to stress tests.

A Large FBO with a Limited U.S. Presence that does not meet the stress testing requirements will be subject to a 105 percent asset maintenance requirement (*i.e.*, its assets must be 105 percent of its liabilities) for its U.S. branches and agencies, and will be required to conduct either (1) an annual stress of its U.S. subsidiaries and report the results of this test to the Federal Reserve, or (2) an enterprise-wide stress test that is approved by the Federal Reserve. The asset maintenance requirement cannot be satisfied by parent support.

4.5 Debt-to-Equity Limit

Although a Large FBO with a Limited U.S. Presence is technically subject to the debt-to-equity limit provisions described in Section 5.5 below, it would seem unlikely to be implicated by this requirement as a practical matter, due to its limited U.S. footprint.

5. *Large FBOs with a Large U.S. Presence*

This section focuses on the prudential requirements applicable to Large FBOs with a Large U.S. Presence. In some cases, these requirements will fall on the IHC, if a Large FBO with a Large U.S. Presence has combined non-branch U.S. assets of $50 billion or more. In other cases, these requirements will fall on the FBO and/or its U.S. branches and agencies.

5.1 IHC Requirement

- **Basic Requirement**. Large FBOs with a Large U.S. Presence with combined non-branch U.S. assets of $50 billion or more will be required to hold all interests in U.S. subsidiaries in the IHC, other than subsidiaries held under Section 2(h)(2) of the BHC Act and DPC Branch Subsidiaries, regardless of whether the FBO owns or controls an insured depository institution in the United States.[3] Branch and agency assets are not required to be held under the IHC, and the IHC must hold the FBO's entire ownership interest in any subsidiary held under the IHC (although an interest in a subsidiary still may be held by a third party). As noted above and discussed below, the IHC essentially is regulated like a U.S. BHC.
- **Alternative IHC Structures**. The Final Rule permits a covered FBO to make a written request to the Federal Reserve for alternative or multiple IHC structures. In evaluating the request, the Federal Reserve may consider whether applicable home-country law would prevent the FBO from controlling its U.S. subsidiaries through a single IHC or whether the activities, scope of operations or structure of the FBO's U.S. subsidiaries warrants consideration of alternative IHC structures. Any request for an alternative structure must be submitted to the Federal Reserve at least 180 days before the FBO is required to form an IHC.
  - The Federal Reserve stated that it does not expect to permit an alternative structure where the purpose or primary effect of the alternative structure is to reduce the impact of the regulatory capital rules or other prudential requirements. For example, the Federal Reserve states in the preamble that it is unlikely to permit an FBO to form a separate U.S. IHC for the sole purpose of holding a nonbank subsidiary separate from its banking operations (other than under circumstances described above), or to designate a company that is not the top-tier company in the U.S. as its IHC.

[3] For purposes of the BHC Act, a "Section 2(h)(2) company" is a company that is owned by a foreign bank and that is principally engaged in the same line of business as its owner outside the United States. These companies are permitted to engage in commercial activities beyond those generally permitted for U.S. BHCs to accommodate the fact that certain foreign jurisdictions permit broader linkages between banking and commercial firms than the United States. *See* 12 U.S.C. § 1841(h)(2).

- The preamble also notes that any requests for a waiver of Section 23A of the Federal Reserve Act to facilitate transfers to an IHC will be considered under the processes set out in the Federal Reserve Act, which require notice and non-objection from the Federal Deposit Insurance Corporation. The Federal Reserve expects FBOs to identify instances in which such waivers may be necessary with their implementation plan.

- **IHC Implementation Plan**. As noted above, FBOs that are required to establish an IHC based on the asset threshold as of June 30, 2014, must submit an implementation plan by January 1, 2015. An implementation plan must include:
  - a list of the FBO's U.S. subsidiaries, including the ownership interest in each subsidiary and an organizational chart showing the ownership hierarchy;
  - a projected timeline for the transfer by the FBO of its ownership interests in those subsidiaries to its IHC;
  - a timeline of planned capital actions or strategies for capital accumulation that will facilitate the IHC's compliance with risk-based and leverage capital requirements;
  - quarterly *pro forma* financial statements for the IHC, including regulatory capital ratios, for the period from December 31, 2015 to January 1, 2018;
  - a description of current risk-management and liquidity stress testing practices, and a plan for complying with the liquidity and risk management requirements of the Final Rule;[4]
  - information regarding any planned exemption requests from the IHC requirement;
  - information regarding Section 2(h)(2) companies and DPC Branch Subsidiaries; and
  - if the FBO plans to reduce assets below the asset threshold for the IHC requirement, a plan for the FBO to do so.[5]

5.2 IHC Risk-based Capital and Capital Planning

- **Overview**. Under the Final Rule and consistent with the Proposed Rules, an IHC will be subject to minimum risk-based capital and leverage requirements as if the IHC were a U.S. BHC. Thus, an IHC will be subject to recently issued final rules implementing

[4] The Federal Reserve may accelerate or extend the date by which the implementation plan must be filed.

[5] Note that the Federal Reserve said it plans to review carefully any transfer of assets to a branch or agency.

the Basel III capital framework in the United States.[6] An IHC will generally become subject to risk-based capital requirements beginning July 1, 2016.

- **Advanced Approaches**. Importantly, and in response to comments, the Final Rule will not require IHCs to comply with the Basel II Advanced Approaches capital framework, even if the IHC otherwise meets the threshold for application of the Advanced Approaches, although such an IHC may elect to use the Advanced Approaches. Moreover, although a large IHC is not required to use the Advanced Approaches unless it elects to do so, many of the other burdens associated with an IHC of sufficient size apply irrespective of whether a particular IHC elects to use the Advanced Approaches (such as the supplemental leverage ratio described in Section 5.3 below).[7]
- **Capital Planning Requirements**. An IHC will also be subject to the capital plan rule adopted for U.S. BHCs in 2011, which requires U.S. BHCs with $50 billion or more total consolidated assets to demonstrate to the Federal Reserve the ability to maintain capital above minimum ratios under baseline and stressed conditions over a nine-quarter time horizon.[8]

5.3 IHC Leverage Capital

Consistent with the Proposed Rules, and despite industry comments, an IHC will be subject to a generally applicable leverage ratio of 4 percent. In addition, an IHC with total consolidated assets of $250 billion or more or total consolidated on-balance sheet foreign exposures of $10 billion or more will be subject to a minimum supplementary leverage ratio of 3 percent. Consistent with the international Basel framework, the Final Rule delays application of the supplementary leverage ratio to covered IHCs until January, 1, 2018. The Final Rule permits the Federal Reserve to accelerate application of the leverage

[6] Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action , Standardized Approach for Risk-weighted assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62018 (Oct. 11, 2013) (Federal Reserve, Office of the Comptroller of the Currency ("OCC")); Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 55340 (Federal Deposit Insurance Corporation ("FDIC")) (interim final rule).

The Debevoise & Plimpton Client Update on the final U.S. Basel III capital rules is available here: http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=6de2459b-3ea5-4da3-b8a3-adb3c2cd9c9b

[7] The Advanced Approaches automatically apply to BHCs with $250 billion or more total consolidated assets or $10 billion or more on-balance sheet foreign exposures, and depository institution subsidiaries with $10 billion or more in total consolidated assets. *See, e.g.*, Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II, 72 Fed. Reg. 69288, 69397 (Dec. 7, 2007).

[8] *See* 12 C.F.R. 225.8 (capital plan rule).

ratio to an IHC if it determines that the covered FBO has taken actions to evade the IHC requirement.

5.4 IHC Risk Management and Risk Committee

- **Risk Management Framework**. The Final Rule requires that an IHC establish and maintain a risk-management framework that is commensurate with its structure, risk profile, complexity, activities, and size and consistent with the risk management policies for the combined U.S. operations of the FBO. The risk-management framework must include policies and procedures establishing risk-management governance, risk-management practices, and risk control infrastructure for the IHC and processes and systems for implementing and monitoring compliance with such policies and procedures.
- **Risk Committee**. An IHC also must establish and maintain a risk committee that approves and periodically reviews the risk management policies and oversees the risk-management framework of the IHC. The risk committee must be a committee of the IHC's board of directors (or equivalent thereof) and, if desired, may serve as the U.S. risk committee for the combined U.S. operations of the FBO. The risk committee must have, at a minimum, (i) one member with experience in identifying, assessing, and managing risk exposures of large, complex ***financial*** firms and (ii) one independent member. If the FBO conducts its U.S. activities solely through an IHC, the risk committee must be maintained at the IHC level.

5.5 IHC Stress Testing

- **General Requirement**. An IHC is subject to the supervisory and company-run stress testing requirements of Section 165(d) of the Dodd-Frank Act and Regulation YY as if the IHC were a U.S. BHC.[9] Thus, an IHC will be subject to annual supervisory stress tests conducted by the Federal Reserve and must conduct annual and mid-cycle company-run stress tests.
- **Timing**. The Final Rule provides for a transition period for the IHC stress testing requirements, which become effective October 1, 2017, although the Federal Reserve retains discretion to accelerate application of the stress testing requirement in cases of evasion. Thus, the first company-run stress test results will be due to the Federal Reserve by January 5, 2018.

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9 The Federal Reserve finalized these stress testing requirements in 2012. *See* Supervisory and Company-Run Stress Tests for Covered Companies, 77 Fed. Reg. 62378 (Oct. 12, 2012).

- Each stress-test cycle for an IHC will begin on October 1 of each year and end on September 30 of the next year.
- **Annual supervisory stress test**: the IHC is required to report information to the Federal Reserve by January 5 of each year, and the Federal Reserve will disclose a summary of the results of its stress test no later than March 31.
- **Annual company-run test**: the IHC is required to report the results of its stress test to the Federal Reserve by January 5 of each year and disclose a summary of the results between March 15 and March 31.
- **Mid-cycle company-run stress test**: the IHC is required to report the results of its stress test to the Federal Reserve by July 5 of each year and disclose a summary of results between September 15 and September 30.

5.6 Capital Certification and Reporting

A Large FBO with a Large U.S. Presence will be subject to regulatory capital certification and reporting requirements, which include requirements to certify to the Federal Reserve on a quarterly basis that on a consolidated basis it meets home-country capital adequacy standards that are consistent with the Basel Capital Framework, including Basel III. An FBO that is not subject to a home-country capital framework consistent with Basel must demonstrate to the satisfaction of the Federal Reserve that it would meet or exceed consolidated capital standards that are consistent with the Basel framework. If a Large FBO with a Large U.S. Presence cannot make this certification, the Federal Reserve may impose requirements, conditions or restrictions relating to the activities or business operations of the FBO's U.S. operations.

In addition, Large FBOs with a Large U.S. Presence will be required to report risk-based capital ratios, risk-weighted and total assets to the Federal Reserve on a quarterly basis. The Federal Reserve said it intends to propose separately amendments to Form FR Y-7Q to incorporate the items that will need to be reported.

5.7 FBO Risk Management Standards

- **Risk Management Framework**. A Large FBO with a Large U.S. Presence must also have a risk-management framework for its combined U.S. operations that is commensurate with the structure, risk profile, complexity, activities, and size of its combined U.S. operations, and must include policies and procedures establishing risk-management governance and consistent with its enterprise-wide risk management policies. The risk-management framework must include policies and procedures

establishing risk-management governance, risk-management practices, and risk control infrastructure for the combined U.S. operations of the FBO and processes and systems for implementing and monitoring compliance with such policies and procedures.

- **Risk Committee**. A Large FBO with a Large U.S. Presence must establish and maintain a risk committee that approves and periodically reviews the risk management policies and oversees the risk-management framework of the combined U.S. operations of the FBO. The risk committee also must approve and review certain liquidity risk management policies and practices.
  - **Committee Membership**. The risk committee must have, at a minimum, (i) one member with experience in identifying, assessing, and managing risk exposures of large, complex ***financial***[10] firms and (ii) one independent member.
  - **Committee Placement**. If the FBO conducts its U.S. activities solely through an IHC (*e.g.*, it does not have a U.S. branch or agency), the risk committee must be maintained at the IHC level. An FBO that conducts its U.S. operations through U.S. branches or agencies (in addition to through its IHC), may maintain the U.S. risk committee (i) on a stand-alone basis or as a part of the enterprise-wide risk committee of the global board of directors (or equivalent thereof) or (ii) on a stand-alone basis or as a part of the risk committee of the FBO's IHC.
- **Chief Risk Officer**. These FBOs also must also appoint a U.S. Chief Risk Officer ("CRO") with experience in identifying, assessing, and managing risk exposures of large, complex ***financial*** firms. The CRO's responsibilities include reviewing the liquidity risks associated with significant new businesses and products, reviewing and approving the contingency funding plan, and reporting to the U.S. risk committee, global CRO and the Federal Reserve. The CRO must be employed by and located at a U.S. entity, report directly to the U.S. risk committee and the global chief risk officer, and receive compensation and other incentives consistent with providing an objective assessment of the risks taken by the combined U.S. operations of the FBO. A complete list of requirements with respect to the CRO is included as Appendix C.

5.8 Liquidity Requirements for IHC and U.S. Operations

Consistent with the Proposed Rules, a Large FBO with a Large U.S. Presence will also be subject to various liquidity requirements, including requirements to conduct liquidity stress tests and maintain liquidity buffers for its IHC (if any), branches and agencies and combined U.S. operations. The Federal Reserve emphasizes that the liquidity

[10] Unlike Publicly-Traded Small FBOs and Large FBOs with a Limited U.S. Presence, risk committees of Large FBOs with Large U.S. Presence must have at least one member that has experience in a ***financial*** firm.

requirements are broadly consistent with existing guidance from the Federal banking agencies on funding and liquidity risk management.[11]

- **Liquidity Stress Tests Overview**. The FBO must conduct monthly liquidity stress tests of projected cash flows, liquidity position, profitability and solvency of its combined U.S. operations, U.S. branches and agencies on an aggregate basis and its U.S. IHC (if any). The FBO must establish a liquidity buffer based on the results of the tests, and is required to make stress test results available to the Federal Reserve, including the results of home-country stress tests.
- **Stress Test Scenarios and Assumptions**. The stress tests must include, at a minimum, scenarios reflecting (i) adverse market conditions; (ii) an idiosyncratic stress event impacting the FBO's IHC (if any) and the U.S. branches and agencies; and (iii) combined market and idiosyncratic stresses. The stress tests must include overnight, 30-day, 90-day and one-year time horizons, as well as any other planning horizon relevant to the liquidity risk profile of the FBO's IHC (if any), U.S. branches and agencies and combined U.S. operations.
  - Internal cash inflows can only be used to offset internal cash outflows, except for stress tests with time horizons longer than 30 days. The restriction on the use of internal cash inflows in the liquidity stress tests in intended to encourage internal maturity matching.
  - For stress tests beyond 30 days, an FBO may include lines of credit as cash flow sources, but should consider the constraints associated with lines of credit.
- **Liquidity Buffers**. The FBO must maintain separate liquidity buffers for its IHC (if any) and branches and agencies. The IHC (if any) and branch and agency buffers must be sufficient to meet projected net stressed cash-flow needs over 30-day and 14-day horizons, respectively. The buffers must be maintained on the balance sheet of the IHC or U.S. branches or agencies, as applicable, and cash may not be held at an affiliate of the FBO (in the case of an IHC, cash may not be held at an affiliate that is not controlled by the IHC). The buffer must consist of assets (i) that are "highly liquid"; (ii) that are unencumbered; and (iii) for purposes of the buffer calculation, are discounted to reflect fair market value, credit risk and market price volatility. The preamble notes that the Federal Reserve anticipates that high-quality liquid assets under the proposed U.S. LCR will qualify as liquid assets for purposes of the buffer.[12]

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[11] *See* OCC, FDIC, Federal Reserve, Office of Thrift Supervision, National Credit Union Administration, Interagency Policy Statement on Funding and Liquidity Risk Management, 75 Fed. Reg. 13656 (Mar. 22, 2010).

[12] The Debevoise & Plimpton Client Update on the proposed LCR is available here: http://www.debevoise.com/newseventspubs/publications/detail.aspx?id=8cf2ea77-7212-42e3-862c-9fcee4cdc794

- **Cash Flow Projections**. The FBO must produce comprehensive cash flow projections for its combined U.S. operations that take into account cash flows from assets, liabilities and off-balance sheet exposures over short and long time horizons and that are tailored to the size, capital structure, risk profile, complexity, currency exposure and activities of the FBO's U.S. operations.
- **Contingency Funding Plan**. The FBO must establish a contingency funding plan that can be implemented during periods of liquidity stress, and identifies liquidity stress events, responsibilities and triggers for invoking the plan, among other items.
  - The FBO must periodically test the plan for its combined U.S. operations to ensure that it functions as intended. The preamble notes that testing should include periodic liquidation of assets, including portions of the liquidity buffer, and that the Federal Reserve believes such actions can be taken without sending a distress signal to the marketplace.
  - Lines of credit can be included as sources of funds in the contingency funding plan, but the FBO should consider the characteristics of such funding sources and how counterparties may behave in times of stress.
  - Parent support also may be included in the contingency funding plan, but the FBO must consider limitations on such support, including the possibility of simultaneous stress.
  - If discount window borrowing is included in the contingency funding plan, the plan should specify how the discount window borrowing would be replaced with more permanent funding.
- **Liquidity Risk Limits**. The FBO must establish limits on sources of liquidity risk, including concentrations of funding by instrument type, single counterparty, counterparty type, secured and unsecured funding and other liquidity risk identifiers; the amount of liabilities that mature within various time horizons; and off-balance sheet exposures and other exposures that could create funding needs during liquidity stress events. The preamble acknowledges that there may be circumstances that warrant exceeding a limit threshold, and therefore escalation procedures should be established that include notification of senior management, the risk committee, and possibly the Federal Reserve.
- **Collateral, legal entity and intraday liquidity risk monitoring**. The FBO must establish a monitoring system to track liquidity risk in collateral positions, legal entities, currencies, business line and intraday liquidity.

- **Independent Review Function**. The FBO must establish and maintain a review function that is independent of the management functions that execute funding for its combined U.S. operations. The independent review function must (i) no less frequently than annually, review and evaluate the adequacy and effectiveness of the FBO's liquidity risk management processes within the combined U.S. operations; (ii) assess whether the FBO's liquidity risk management function complies with applicable laws; and (iii) report material liquidity risk management issues to the U.S. and enterprise-wide risk committee.

5.9 FBO Stress Testing Requirements

- **Home-Country Standards**. A Large FBO with a Large U.S. Presence must also be subject to a consolidated capital stress testing regime in its home country, which must include (i) an annual (x) supervisory capital stress test conducted by the home-country supervisor or (y) evaluation and review by the home-country supervisor of an internal capital adequacy stress test conducted by the FBO and (ii) requirements for governance and controls of stress testing. The FBO must meet minimum standards set by its home-country supervisor with respect to stress tests.
- **Stress Test Reporting**. The FBO must report detailed information to the Federal Reserve by January 5 of each calendar year about its stress tests, including: (i) a description of the types of risks, conditions, scenarios and methodologies used in the stress test; (ii) estimates of aggregate losses, pre-provision net revenue, loan loss provisions, pre-tax net income and *pro forma* regulatory capital ratios under home-country standards; and (iii) an explanation of the most significant causes for any changes in regulatory capital ratios. If the FBO's U.S. branches and agencies are in a "net due from" position, the FBO is required to report more detailed information about the methodologies used in and the results of the stress tests.
- **Additional Standards**. A covered FBO that does not meet these stress testing requirements will be subject to a higher 108 percent asset maintenance requirement for its U.S. branches and agencies. In addition, if the FBO has not established an IHC, the FBO will be required to either conduct (1) an annual stress test of its U.S. subsidiaries and report the results of this test to the Federal Reserve, or (2) an enterprise-wide stress test that is approved by the Federal Reserve. In addition, the Federal Reserve may impose intragroup funding restrictions or additional liquidity requirements on the U.S. operations of the FBO. The asset maintenance requirement cannot be satisfied by parent support.

5.10 Debt-to-Equity Limit

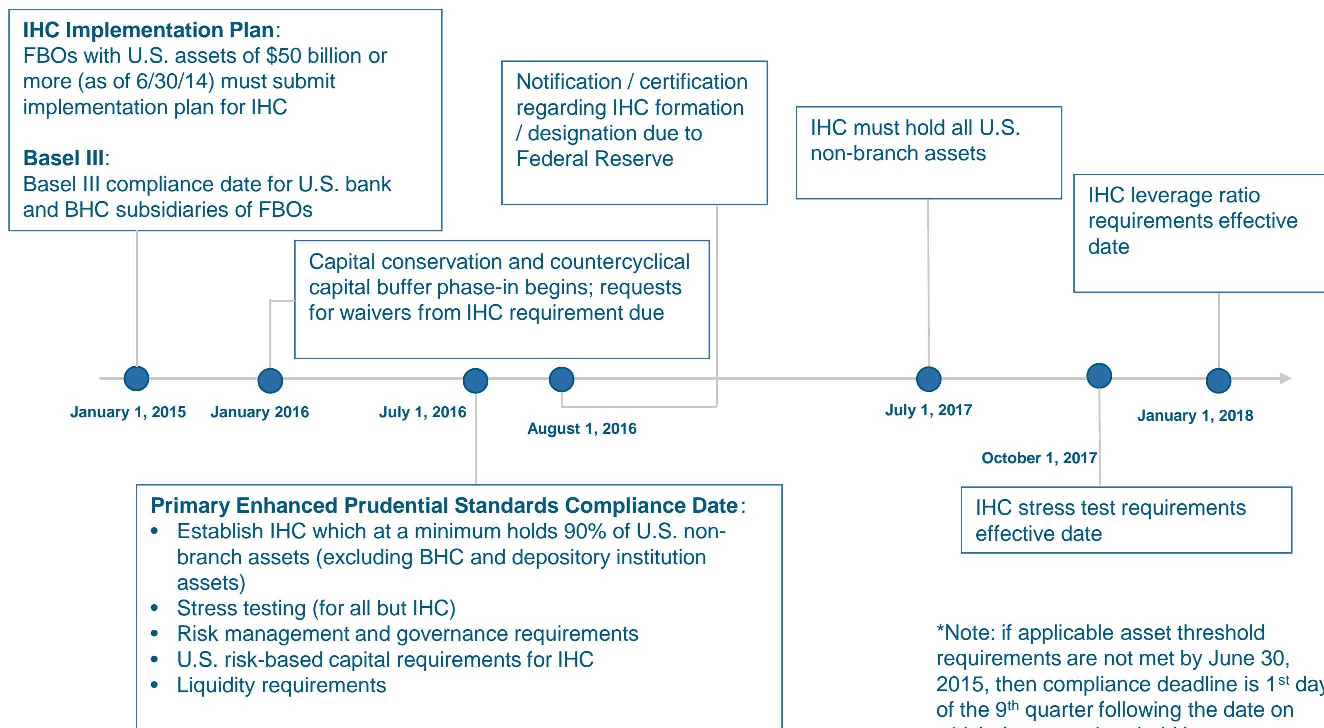
Consistent with Section 165(j) of the Dodd-Frank Act, the Final Rule provides that the Federal Reserve may impose a 15-1 debt-to-equity ratio on an IHC and any U.S. subsidiary not organized under an IHC (other than a company held under Section 2(h)(2) of the BHC Act and branch subsidiaries held under DPC Branch Subsidiaries) if the FSOC determines that the FBO poses a grave threat to the financial stability of the United States and the imposition of the debt-to-equity requirement is necessary to mitigate this risk (to date no such FSOC determination has occurred). Upon such a finding, the U.S. branches and agencies of the FBO would be subject to a 108 percent asset maintenance requirement.

* * *

Please do not hesitate to contact us with any questions.

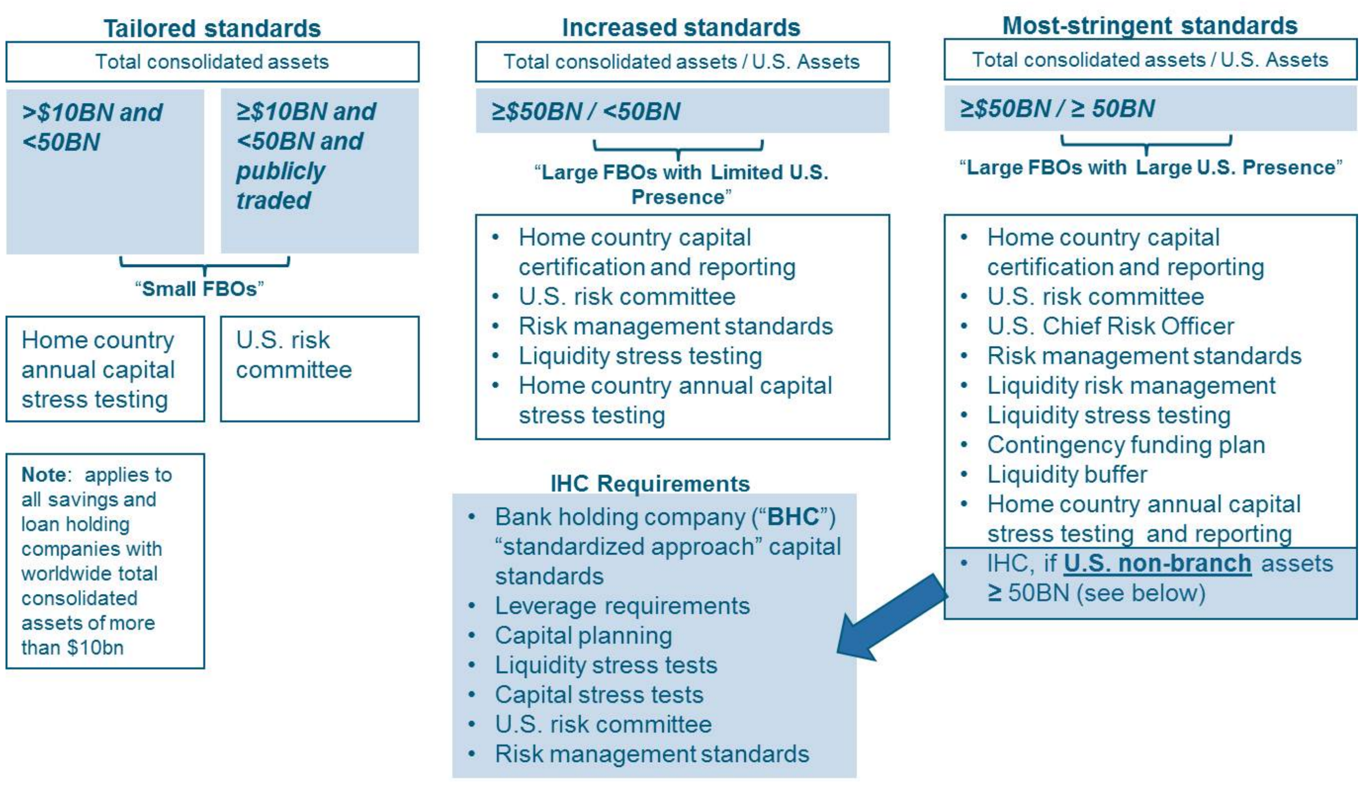
February 27, 2014

Appendix A: Compliance Timeline



*Note: if applicable asset threshold requirements are not met by June 30, 2015, then compliance deadline is 1st day of the 9th quarter following the date on which the asset threshold is met

Appendix B: Scope and Coverage



Appendix C: Responsibilities of the U.S. Chief Risk Officer

General Risk. The CRO oversees:

- The measurement, aggregation, and monitoring of risks undertaken by the combined U.S. operations
- The implementation of and ongoing compliance with the policies and procedures for the combined U.S. operations established in its risk-management framework
- The management of risks and risk controls within the parameters of the risk-control framework for the combined U.S. operations, and the monitoring and testing of such risk controls

Liquidity Risk. The CRO:

- Reports risks and risk-management deficiencies of the combined U.S. operations, and resolves such risk-management deficiencies in a timely manner
- Reviews the strategies, policies and procedures established by senior management of the U.S. operations for managing the risk that the financial condition or safety and soundness of the FBO's combined U.S. operations would be adversely affected by its inability or the market's perception of its inability to meet its cash and collateral obligations
- Reviews information provided by the senior management of the U.S. operations to determine whether the combined U.S. operations are operating in accordance with the established liquidity risk tolerance
- Regularly, and, at least semi-annually, reports to the FBO's U.S. risk committee and enterprise-wide risk committee, or the equivalent thereof, on the liquidity risk profile of the combined U.S. operations and whether it is operating in accordance with the established liquidity risk tolerance for the U.S. operations, and establishes procedures governing the content of such reports
- Approves new products and business lines and evaluates the liquidity costs, benefits, and risks of each new business line and each new product offered, managed or sold through the combined U.S. operations that could have a significant effect on the liquidity risk profile of the U.S. operations of the FBO
- In determining whether to approve the new business line or product, the U.S. chief risk officer must consider whether the liquidity risk of the new business line or product (under both current and stressed conditions) is within the FBO's established liquidity risk tolerance for its combined U.S. operations

- Reviews at least annually significant business lines and products offered, managed or sold through the combined U.S. operations to determine whether each business line or product creates or has created any unanticipated liquidity risk, and to determine whether the liquidity risk of each strategy or product is within the FBO's established liquidity risk tolerance for its combined U.S. operations
- Reviews the cash-flow projections at least quarterly (or more often, if changes in market conditions or the liquidity position, risk profile, or financial condition of the FBO or the U.S. operations warrant) to ensure that the liquidity risk of the combined U.S. operations is within the established liquidity risk tolerance
- Establishes liquidity risk limits and reviews the FBO's compliance with those limits at least quarterly (or more often, if changes in market conditions or the liquidity position, risk profile, or financial condition of the U.S. operations of the FBO warrant)

Liquidity Risk Stress Testing. The CRO:

- Approves liquidity stress testing practices, methodologies, and assumptions at least quarterly, and whenever the FBO materially revises its liquidity stress testing practices, methodologies or assumptions
- Reviews the liquidity stress testing results at least quarterly
- Approves the size and composition of the liquidity buffer at least quarterly